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Facilitating Out-of-Court Workouts in a Crisis: Lessons From East Asia, 1998-2001

by

Mr. William P. Mako, Senior Analyst, Private Sector Development Department The World Bank

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As seen in the recent East Asia crisis, government responses to a "financial" crisis tend to focus on the resolution of financial sector distress. In fact, financial sector and corporate sector distress are intertwined – especially in cases where debt-fueled over-investment by corporations in low-margin, loss-making, or cyclical businesses encouraged the crisis. Failure to resolve underlying corporate distress through adequate "operational restructuring" risks a diminution of long-term corporate competitiveness and a recurrence of acute corporate distress upon the expiration of crisis-related "financial restructuring" concessions from creditors.

Following an introductory discussion of corporate-financial sector linkages and issues in the operational and financial restructuring of distressed corporations (Section I), this chapter summarizes approaches taken in the recent East Asia crisis to out-of-court workouts (Section II) and corporate restructuring results through mid-2001 (Section III). Subsequent discussion of lessons first considers process-related items that should be easy to implement, for example, the organization and operation of creditors committees (Section IV). The chapter concludes by highlighting difficult issues pertaining to the allocation of losses among debtors and creditors: the ability of creditors to impose losses on a debtor; the government's readiness to force or induce creditors to recognize losses from corporate restructuring; and the resolution of inter-creditor differences on the allocation of losses and risk among creditors (Section V). Failure to resolve these issues will cripple any out-of-court workout scheme.

I. Corporate-Financial Sector Linkages

Corporate and financial sector restructuring are two aspects of the same problem. The amount of debt a company can sustain – and on which lenders can expect reliable debt service – is determined by the company's cash flow (see Box 1). Indeed, a company cannot sustain interest payments in excess of its cash flow (i.e., interest coverage of less than 1:1), let alone make any repayments on principal.

Box 1. Measuring a Company's Sustainable Debt

So long as management is not manipulating earnings and working capital (e.g., by booking un-collectible receivables and revenues), a company's earnings before interest, taxes, depreciation, and amortization (EBITDA) is a reasonable measure of cash flow and indicator of sustainable debt. Using a 2:1 interest coverage standard and assuming a market interest rate of 8%, for example, a company with EBITDA of $100 million could sustain debt of $625 million.

An EBITDA/interest expense ratio of less than 1:1 is unsustainable; the company could not meet all its interest obligations, let alone repay any principal. Any ratio below 2:1 is worrisome. For example, Korea's Dong-ah Construction was forced into receivership in 2000 despite 1999 interest coverage of 1.6:1.

There are a number of ways to resolve unsustainable corporate debt, some better than others. The best response would be for the company to raise new equity and/or undertake "operational restructuring" – e.g., discontinuation of less profitable or loss-making ("non-core") businesses, layoffs of excess labor, and other cost reductions to increase the company's earnings and debt service capacity, plus sales of non-core businesses and assets (e.g., real estate) to retire debt. If it appears that operational restructuring cannot reduce corporate debt to a sustainable level, "financial restructuring" becomes appropriate. For example, creditors could convert debt into equity or into lower-yielding convertible bonds. To avoid moral hazard, creditors should contemplate debt write offs *only after* having exhausted all other approaches and should retain some instrument (e.g., equity, options, warrants) to participate in any recovery. Term extensions may be acceptable, so long as these do not have the practical effect of transforming debt into an equity-like instrument without also giving creditors the rights of equity-holders. Reducing interest below the risk-adjusted rate may also be acceptable, so long as principal is repaid. Grace periods on debt service – especially on interest payments – usually just postpone the day of reckoning for nonviable companies. In cases where deferred debt service is re-scheduled into a large "balloon" payment due after several years, it is likely that the company will relapse into distress unless it uses this breathing space to address fundamental problems through operational restructuring.

Turning to the financial sector side, the creditor(s) of a corporation under restructuring should provision – and, as necessary, further reduce its capital – to reflect (i) the present value effects of any debt/equity conversions, rate reductions, term extensions, grace periods, and write offs and (ii) appropriate provisioning of remaining corporate debt based on international-standard forward-looking criteria. If these measures reduce a financial institution's risk-weighted capital below some ratio (e.g., 8%), the government may decide to close and liquidate the institution, merge it with a stronger partner, insist on additional capital from current shareholders, or re-capitalize the institution and take control. Thus, corporate cash flow is linked (i) to the amount of sustainable corporate debt and (ii) to the cost of re-capitalizing financial institutions for losses in resolving the non-sustainable portion of corporate debt. In any case where financial restructuring of a distressed corporation involves a debt/equity conversion, financial institution shareholders will also need to make arrangements for managing and eventually selling the converted equity.

Corporate debtors and financial institution creditors will naturally seek to minimize their losses from corporate restructuring. Losses may include, in addition to things of monetary value, diminutions of autonomy or prestige. For example, a corporation's management and controlling shareholders will seek to avoid outside interference, loss of control, dilution of their equity interest, or sale or closure of favored lines of business and assets. A financial institution's management and controlling shareholders will seek to avoid losses on corporate debt restructuring that could necessitate capital write-downs leading to equity dilution, loss of control, and nationalization, forced acquisition, or liquidation of the institution.

The government will have to balance a variety of conflicting interests. These may include minimizing the costs of bank re-capitalization; protecting workers, suppliers, and subcontractors of failed companies and minimizing ripple effects through the economy; minimizing distortions to market competition through excessive debt-rescheduling concessions; avoiding labor strife; and – last but not least – dampening public criticism enough for the government to remain in office.

From the perspective of the distressed company itself (as distinct from its shareholders), it is reasonable to suggest time-phased restructuring goals.

- In the *short-term* (e.g., 3 months), it will be important to achieve some financial stabilization in order to prevent the liquidation of viable albeit over-leveraged companies. Non-viable companies should be allowed to fail and exited, e.g., through liquidation. In a systemic crisis, however, "strong swimmers" should not be dragged down along with the weak in the widespread "liquidity crunch" that typically occurs in a crisis.

- In the *medium-term* (e.g., 6-24 months), operational restructuring along the lines mentioned earlier should be undertaken to improve the company's profitability, solvency, and liquidity.

- Over the *longer-term*, it is important to deter a recurrence of imprudent debt-fueled corporate investment. Such deterrence depends on a demonstrated quick and reliable ability by wronged creditors to foreclose on assets, liquidate non-viable companies, and seize viable but distressed companies from uncooperative shareholders/managers.

II. Recent Approaches to Out-of-Court Workouts

Recognizing that the resolution of hundreds or thousands of large corporate distress cases through insolvency law frameworks would quickly overwhelm local courts, Korea, Malaysia, Thailand, and Indonesia all adopted local variants of the "London approach" that the Bank of England had promulgated in the 1980s.

Korea. In July 1998, with encouragement from the Financial Supervisory Commission (FSC), 210 local financial institutions embarked on a contractual approach to out-of-court workouts as an alternative to unsupervised "bankruptcy avoidance loans (i.e., bailouts) and court-supervised insolvency. These institutions signed a Corporate Restructuring Agreement (CRA) that provided for a 1-3 month standstill (depending on due diligence requirements), that could be extended for 1 month; a creditors committee led by a lead creditor, typically the chaebol's lead bank; a 75% threshold for creditor approval of a workout agreement; a 7-person Corporate Restructuring Coordination Committee (CRCC), selected by signatories, to provide workout guidelines and arbitrate inter-creditor differences in cases where creditors could not approve a workout plan after three votes; and CRCC imposition of fines (up to 30% of a credit or 50% of the amount of non-compliance) for non-compliance with an arbitration decision.[1] Other key factors included a strong creditor rights/insolvency system, the nationalization of Korea's largest banks, and an increasingly active role for the Korea Asset Management Company (KAMCO). In the Daewoo workouts, KAMCO bought $4.4 (?) billion in debt from foreign creditors to smooth the way for agreement among domestic creditors.

Malaysia. A Corporate Debt Restructuring Committee (CDRC) was established in August 1998 with secretarial support from Bank Negara Malaysia (BNM) to provide a forum and framework for creditors and debtors to reach voluntary agreement. Either the debtor or its creditors could initiate a CDRC case. Eligibility for CDRC status was eventually raised to any case involving at least RM100 million in debt and five or more financial institution creditors. CDRC also provided for a creditors committee representing at least 75% of credits (later reduced to 50%) for each company; full information-sharing; creditor committee appointment of independent consultants to review or develop workout options; a standstill period of 60 days (extendable) to assess viability and financial needs; and 100% creditor approval for CDRC cases. Such a high threshold for creditor approval was consistent with the view of CDRC as a forum for facilitating purely voluntary agreements. But lower creditor approval thresholds for other types of cases – e.g., 75% for court-supervised reorganizations, 50% for workouts managed by the Danaharta public AMC – may have given creditors an incentive to reach agreement in CDRC proceedings. CDRC acted as an advisor and mediator between debtors and their creditors. On at least some occasions, dissenting creditors were bought out by Danaharta. In addition, BNM reportedly used its influence on occasions to persuade hold-out banks to accept workout banks supported by a majority of creditors. Other key factors included a strong creditor rights/insolvency system; the powerful Danaharta AMC; and a thoughtful approach to segmenting corporate distress and linking corporate and financial sector restructuring. The largest corporate cases went to CDRC, while Danaharta handled mid-sized cases and smaller cases remained with the workout departments of individual banks. Banks were required to sell "excess" NPLs to Danaharta. Subsequently, the Danamodal agency would provide any necessary bank re-capitalization and financial sector restructuring.[2]

Thailand initially pursued a purely consensual approach, but soon adopted a contractual approach to out-of-court workouts. The Corporate Debt Restructuring Advisory Committee (CDRAC) was formed within the Bank of Thailand (BOT) in June 1998. CDRAC, which was chaired by the BOT governor, included representatives from creditor and debtor interest groups. CDRAC members identified priority cases, developed a set of principles and timeline to guide voluntary workouts (the

[1] Financial Supervisory Commission, "Corporate Restructuring Agreement," July 1998.

[2] R. Thillainathan, *The Malaysian Financial System*, December 2001, mimeo.

"Bangkok Rules"), attempted to facilitate and monitor restructuring negotiations, and attempted to resolve legal and regulatory impediments to corporate restructuring. By end-1998, however, only about $3.5 billion in CDRAC case debt had been restructured. This prompted BOT to play a more active role in monitoring and to promote a more contractual approach. BOT promulgated two model civil contracts: a Debtor-Creditor Agreement (DCA) to govern out-of-court agreements and an Inter-Creditor Agreement (ICA) to resolve differences among creditors. DCA signatories agreed on a 6-8 month schedule for developing and approving a restructuring plan; information-sharing; designation of a lead creditor or steering committee; and thresholds for creditor approval. Approval by 75% of creditors was necessary to ratify a restructuring plan – the same threshold as for a court-supervised reorganization. In cases where creditor support was just 50-75%, the plan could be amended and resubmitted for another vote. In cases where creditors could not agree on a plan, the DCA provided for cases to be forwarded to the courts for resolution under existing creditor rights/insolvency law. In cases of inter-creditor differences, the ICA provided for a 3-person panel to arbitrate differences, but included an easy escape clause for concerned creditors. The DCA and ICA empowered the BOT to levy fines and reprimands to enforce creditor compliance, including requirements for creditors to file court petitions following a breakdown of the workout process.[3] Other key factors included weakness in Thailand's creditor rights/insolvency system; the government's reluctance to nationalize or force the public re-capitalization of Thailand's biggest banks; and various legal/regulatory impediments to corporate restructuring.

Indonesia also initially pursued a purely consensual approach to out-of-court workouts, but later tried a more directive approach. While the Indonesia Bank Restructuring Agency (IBRA) AMC was expected to resolve corporate credits extended by Indonesia's largely-nationalized financial sector, the Jakarta Initiative Task Force (JITF) was established in September 1998 to resolve corporate credits from foreign banks. JITF's initial focus was on advice, facilitation, and mediation and on the identification and removal of tax, legal, or regulatory impediments to corporate restructuring. The JITF was originally designed as a voluntary program under the assumption that a new Bankruptcy Law would provide a remedy in cases where the parties could not negotiate a workout agreement in good faith. By end-1999, however, JITF debt workout agreements reached only $1.3 billion. Hence, in April 2000, JITF was given some ability to orchestrate regulatory relief or sanctions and to impose a time-bound mediation process. A debtor and its creditors were given an opportunity to agree on a mediation schedule. If the parties failed to agree, a mediation schedule could be set by JITF, which would monitor progress and mediate any disputes. If it determined that a party was behaving in an uncooperative manner or that progress could not be made, the JITF could terminate mediation and file a report with the government's Financial Sector Policy Committee (FSPC). In turn, the FSPC could refer an uncooperative debtor to the Attorney General for initiation of bankruptcy proceedings – an option that had not been used as of mid-2001. Other key factors included the complete lack of any protection for creditor rights,[4] the dominant role of IBRA in many corporate restructuring negotiations, and various legal/regulatory impediments to corporate restructuring.

III. Results

Numbers of workout cases sometimes turned out to be not all that large, for instance, less than 100 cases each in Korea and Malaysia. The size of Korean cases, however, was substantial, in particular the Daewoo workouts which involved about $60 billion in distressed debt. Thailand was an anomaly in terms of more ambitious efforts there to pursue out-of-court workouts. In Thailand, the CDRAC process was applied to almost 15,000 cases, including almost 3,000 large corporations and 12,000 small/medium enterprises, for which a "lite" version of the Debtor-Creditor Agreement was developed (see Table 1). By mid-2001, restructuring agreements had been reached for more than three-quarters of the workout caseloads in Korea and Malaysia.[5] Completion rates were closer to one-

[3] Cite study by World Bank Bangkok office

[4] See article by PricewaterhouseCoopers in ADB volume, 2001.

[5] Practically speaking, Korea's completion rate was nearly 100%. Companies that dropped out of the workout program typically converted into court-supervised insolvencies.

half in Thailand and Indonesia. In Thailand, as of July 2001, it was expected that failed CDRAC cases would revert to the courts and that the courts would need 7+ years to resolve a combined backlog of over 65,000 NPL cases.

Table 1. Overview of Workout Results (currency in US$ millions)

	South Korea (1)	Malaysia (2)	Thailand (3)	Indonesia (4)
Total credits assigned for resolution	88,917	10,395	65,500	18,900
Assigned cases	83	54	14,917	n.a.
Resolution:				
Cases	68	46	6,345	n.a.
% of assigned credits	95%	77%	48%	56%
Ratio of financial:operational restructuring	5.1	40.5	n.a.	13.3
New money	3,667	n.a.	n.a.	n.a.

Sources: Financial Supervisory Commission; R. Thallianathan; World Bank Bangkok office; Jakarta Initiative Task Force; and staff estimates

Notes: 1. Only includes Corporate Restructuring Agreement cases. Data as of June 2003. Financial operational restructuring ratio applies only to pre-Daewoo workouts agreed by July 1999 2. Corporate Debt Restructuring Committee cases, as of end-June 2001. Ratio of financial: operational is for End-1999 forward to formal legal documentation and implementation

Focusing on completed workout cases, what was accomplished relative to the time-phased corporate restructuring goals suggested earlier?

As the crisis developed, it became apparent that short-term financial stabilization of distressed corporations was not an immediate operational issue, but was instead a longer-term "credit culture" issue. Probably no well-run large corporation in East Asia was driven out of business by the crisis-induced "liquidity crunch."[6] Rather, the key issue was whether financial stabilization resulted from a formal standstill supported and monitored by creditors or from do-it-yourself "strategic defaulting." In Korea, a company's acceptance into the CRA workout program immediately led to due diligence and monitoring by creditors and their advisors. All too frequently in Thailand and Indonesia, debtor companies could indefinitely resist creditor entreaties to allow due diligence or supervision or to engage in good faith negotiations. While previous management and/or controlling shareholders may have remained in place at many such companies, reputations and company access to financing have presumably suffered. The alternative of formal creditor standstills, due diligence, and supervision is far preferable in terms of long-term support for the development of credit culture and business finance.

On the question of medium-term operational restructuring, it is impossible to say how much is enough without looking at individual companies. Four years after the start of the crisis, a bottom quartile of Korean corporations suffered from increasing losses, high debt, and increasingly negative cash flow. From available data on operational restructuring or other "self help" (e.g., asset sales, cost reductions, new equity) and financial restructuring concessions by creditors (e.g., debt rescheduling, debt/equity conversions), however, it does appear that operational restructuring played a bigger role in

[6] The same cannot be said for small/medium enterprises. In South Korea, for example, almost 19,000 small/medium enterprises failed in 1997/98. Kawai, Lieberman, Mako, "Financial Stabilization and Initial Restructuring of East Asian Corporations," p. 79. Greater attention should probably be paid to short-term financial stabilization and liquidity for SMEs in a crisis.

Korea's corporate restructuring than in the other East Asia crisis countries. For the initial round of workouts agreed as of July 1999, the ratio of financial restructuring to operational restructuring was about 5:1. Subsequent workout agreements covering $56 billion in Daewoo debt seemed to focus almost exclusively on financial restructuring. In retrospect, however, it appears that the focus of creditors was on gaining near-term control in order to proceed with the follow-on sale or operational restructuring of Daewoo affiliates, which has in fact happened.[7] By contrast, ratios of financial restructuring to operational restructuring were higher for Indonesia's JITF workouts (at 13:1) and for Malaysia's CDRC workouts (at 40:1, as of end-1999). For JITF cases at the term sheet stage as of May 2001, 57% of the debt was to be rescheduled (with an average term of 7 years and 2.6 years grace on principal), 36% was to be converted into equity or convertible bonds, and 7% was subject to cash settlement or debt/asset swap.[8] In Malaysia, of $3.5 billion in debt restructured as of end-1999, promised asset sales and new equity amounted to only $85 million. Two large cases involving the conversion of $2.24 billion of short-term debt into 7-year zero-coupon bonds were especially controversial.[9] Such "balloon payment" arrangements appear to have featured prominently in Malaysia, Thailand, and Indonesia. The risk, of course, is that operationally-flabby corporations will relapse into acute financial distress when grace periods expire and debt service demands resume. Indeed, corporate debt default recidivism has been an issue.

As for the long-term deterrence of imprudent debt-financed investment by corporations, Korea appears to have sustained its early success in addressing this moral hazard issue. Since 1996, at least twenty-five large companies involving $33 billion in debt have gone into court receivership.[10] In the Daewoo matter, creditors gained management control and displaced previous controlling shareholders in relatively short order. Following some waffling in late 2000, debt restructurings for three Hyundai companies (including Hynix Semiconductor) displaced family ownership interests and left creditors in control.[11] Thus, Korea has sustained the lessons that no chaebol is "too big to fail" and that imprudent debt-financed investment can result in a complete loss of ownership and control. A credible and imminent threat of receivership inclined the management and controlling shareholders at other chaebols to cooperate in good faith with out-of-court workout efforts. While workouts typically imposed a loss on chaebol insiders (e.g., from equity dilution, creditor supervision, forced asset sales), half a loaf was apparently better than none. In Thailand and Indonesia, where the lack of a credible immediate threat of total loss from liquidation, foreclosure, or receivership have made it easier for debtor companies to stiff their creditors, the lesson is muddled. The deadbeat corporate manager/controlling shareholder may manage to hang on, but future access to market financing will presumably suffer for some unforeseeable period of time.

Discussion in subsequent sections will suggest that above-mentioned differences in the quantity and quality of corporate restructuring have less to do with process or legal/regulatory impediments than with basic issues over the allocation of losses among the debtor and its creditors.

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[7] For example, Korea Investor Service data show that employment declined by 25-30% at Daewoo Heavy and Daewoo Motor Sales, 45% at Ssangyong Motors, and almost 60% at Daewoo Corporation between end-1996 and end-2001. Moreover, some affiliates have been sold, including Daewoo Motors' sale to General Motors. Daewoo Corporation has been split into 3 companies (2 good, 1 bad), as has Daewoo Heavy. These spin-offs of Daewoo Corporation's trading and construction businesses and Daewoo Heavy's shipbuilding and heavy machinery businesses were somewhat delayed – first by the need to legislate tax relief for spin-offs, and second by the need to negotiate preferential equity restructuring terms with public shareholders.

[8] JITF Quarterly Report, June 2001.

[9] These cases, involving engineering concern UEM/Renong, saw no change in management, dilution of existing shareholders, new equity, or asset sales. Indeed, it was reported in the press at the time that UEM/Renong actually acquired additional assets.

[10] Kawai, Mako, and Lieberman, op cit., p. 79 and Wonhyuk Lim, "Korea: Corporate Vulnerabilities and Restructuring," mimeo, September 2002, pp. 29-30.

[11] Lim, op cit, p. 14.

IV. Easy Lessons

Recent experiences from East Asia workout regimes point to some easy items that need to be in place for a successful workout regime. These include appropriate principles and processes; resolution of tax, legal, or regulatory impediments to corporate restructuring; and responses to inevitable capacity constraints.

Principles and processes. In each of the four crisis countries, highly-qualified professionals put a great deal of thought into appropriate principles and processes to guide out-of-court workouts. One example was the improved guidelines in Malaysia, which CDRC adopted in August 2001 after the previously-mentioned controversy over some workout agreements (see Box 2). Another example is the standard model for memoranda of understanding for Korean workouts (see Box 3).

Box 2. Malaysia: Enhanced August 2001 Rules for CDRC Workouts

Standstill Agreement

- 90-day standstill binding on all creditors
- Allows for appointment of monitoring accountants and special audits
- Creation of special debtor accounts to ensure payment of operating expenses, advisors, and debt service
- Undertakings by debtor regarding information disclosure, inter-company lending, asset transfers, dividends, new borrowing, and investments
- Continued debtor use of collateral
- Creditors maintain credit lines; no increase in creditor claims; no acceleration; no change in creditor priorities, other than for new money; no set offs
- Standstill may be extended once

Financial Restructuring

- Shareholders to take bigger “haircut” than creditors
- Debt to be restructured into equity, quasi-equity, and debt
- Common interest rate within same creditor class; maximum interest rate differential between classes of 1%
- Waiver of penalty interest
- Periodic payment of interest
- Usage of funds to be designated; financial covenants included in agreement
- Sharing of surplus from disposal of unencumbered assets
- All concessions clawed back in case of failure

Operational Restructuring

- Changes in company management and board of directors, as appropriate
- Disclosure of related-party transactions
- Divestiture and/or liquidation of non-viable and non-core assets

- Asset sales to be agreed by creditors committee

- Implementation monitoring by accountants and special audits; regular reporting and establishment of operational covenants.

Source: R. Thillainathan, *"The Malaysian Financial System," December 2001.*

Box 3. Korea: Typical Content of Workout Agreements

Commitments by Debtor

- 5-year management targets for debt reduction; sales; and operating income;

- "Self rescue" plan for asset sales, sales of businesses, workforce reductions, and other cost-cutting measures;

- Consent of labor union and controlling shareholders;

- Monitoring by management and creditors' Joint Management Team (JMT), including JMT approval of annual business plan; monthly un-audited financial statements; right of creditors to replace management for failure to meet performance targets; JMT control of cash management; and requirement for creditor approval of capital expenditures, dividends, rights offerings, or disposition of production facilities;

- Creditor's right to appoint outside directors and auditor;

- Equity write-downs or mergers

Commitments by Creditors

- Cooperation in implementation of agreed workout plans;

- Establishment of Joint Management Team

- Debt rescheduling

- New credits;

- Sanctions for non-compliance (e.g., foreclosure, penalty interest, management changes, suspension of new credits; acceleration or call of existing credits; suspension from workout program; sale of converted debt and convertible bonds).

- Terms for graduation from workout and end to JMT monitoring

These examples, along with the earlier description of creditor approval mechanisms, provide many worthwhile ideas that may well be suitable for workout regimes for future crises. As the ineffectual Bangkok Rules showed, however, the real challenge is not to identify appropriate principles and procedures but rather to make them stick.

Legal/regulatory impediments. East Asia experience highlights the number and variety of tax, legal, or regulatory issues that can arise to impede corporate restructuring. For example:

- Gains to the debtor from financial restructuring may be treated as taxable income. Conversely, creditors may not be able to deduct losses from financial restructuring concessions to reduce their taxes. There may be VAT, stamp duty or other fees on asset sales or debt/asset swaps. Non-cash corporate reorganizations, such as mergers or spin-offs, may be treated as a taxable event. Opportunities to transfer tax-loss carry-forwards to corporate acquirer or new merged entity may be limited or non-existent.

- Corporate mergers or acquisitions may be constrained, for example, by a multi-month waiting period during which creditors may object and demand immediate repayment.

- Employees of state-owned financial institutions may be personally liable for agreeing to any corporate restructuring agreement that causes a loss to the financial institution.

- Banking laws or regulations may limit the amount of converted corporate equity that a financial institution can accept, or require its prompt sale.

- For a financial institution with diminished capital, acceptance of a restructuring agreement for an extra-large corporate credit may change a *de facto* legal lending limit violation into a violation more formally approved by the financial institution's management.

- The threat of local stock exchanges to de-list distressed corporations or any requirement to organize a tender to buy-out public shareholders may discourage debt/equity conversions. In addition, the ability of banks to hold converted corporate equity may be time-bound or subject to ceilings.

- Outsider public shareholders exercising their shareholder rights may oppose dilution of their equity and demand preferential terms in any debt/equity conversion.

All possible impediments should be identified at the outset of the crisis. In some cases, specific waivers (e.g., on legal lending limits) or permanent or time-bound general relief (e.g., on tax effects) may be appropriate. Alternatively, workout regime secretariats may pursue regulatory waivers for particular restructuring cases. While some such secretariats, the JITF in particular, heavily emphasized such waivers, there is no indication or reason to believe that such "carrots" ever induced debtor companies or financial institution creditors to take additional losses. While likely necessary, regulatory relief is not sufficient to induce restructuring. Public shareholder rights to oppose dilutive equity restructuring may be impossible to override in an out-of-court workout, as seen in the Daewoo spin-offs in Korea. To deal with perfectly valid protections for public shareholders, it may be necessary to link out-of-court workouts to efficient court-supervised processes (e.g., "pre-packaged" reorganizations) to effect equity restructuring.

Capacity constraints. It is essential both to build implementation capacity and to design a resolution strategy around inevitable capacity constraints. Capacity needs are likely to include more and better bankruptcy judges and administrators, bank workout personnel, and a crisis resolution team for the government. Requirements for responding to systemic corporate and financial sector distress, however, can easily absorb all the accounting, legal, banking, and corporate turnaround expertise in a crisis country. Thus, it is also important to plan to work around likely capacity constraints. The assignment of almost 15,000 distressed companies to CDRAC in Thailand was probably unrealistic under the best of circumstances. Some segmentation of corporate distress – e.g., large multi-creditor cases in out-of-court workout or court-supervised insolvency, medium-sized cases in an AMC, and small cases remaining with the originating bank – such as followed in Malaysia, seems to make the most sense. Limiting AMC mandates to the sale of un-restructured corporate debt (versus financial restructuring or follow-on operational restructuring) will lessen demands on AMC capacity and offer a higher chance of success. Joint ventures to induce professional private management of distressed corporate debt or converted equity, such as successfully used in Korea by KAMCO and corporate restructuring companies (CRCs), are another way of addressing capacity constraints.[12]

V. Potential Deal-Breakers

Workout principles and process, legal and regulatory impediments, and capacity constraints are the easy issues. Recent experience indicates that the success of an out-of-court workouts scheme – measured in terms of the quantity and adequacy of corporate restructuring – will ultimately depend on the ability of creditors to impose losses on a debtor; the government's readiness to force or induce creditors to recognize losses from corporate restructuring; and the resolution of inter-creditor differences on the allocation of losses and risk.

Debtor losses. Serious financial and operational restructuring of distressed companies will impose some losses on corporate managers and controlling shareholders, for example, through equity dilution, creditor monitoring, diminution of managerial discretion, or forced divestiture of favored businesses and assets. Debtors involved in an out-of-court workout or court-supervised rehabilitation can be expected to resist such measures unless there is a credible timely threat of even greater loss, for example, through foreclosure, liquidation, or receivership.

Contrasts between Korea and Indonesia/Thailand are instructive. While additional operational restructuring of Korea's bottom quartile of distressed companies is still needed, the 1989/99 workouts did impose significant losses on corporate insiders from equity dilution, management changes, creditor supervision, and forced asset sales. In Korea, a low performance threshold for receivership gave creditors a powerful "stick."[13] The 1997 decent of eleven chaebols into receivership provided an incentive for other corporate debtors to agree in 1998/99 to lesser losses imposed by out-of-court workout agreements. In Indonesia, however, the absence of any credible threat to debtors has encouraged a dilatory and superficial approach to corporate restructuring. In Thailand, as seen in the infamous TPI case, the lack of a credible threat of foreclosure, liquidation, or receivership has produced the anomalous spectacle of prolonged debtor resistance to court-supervised rehabilitation.

To elicit sufficient debtor cooperation with either an out-of-court workout or court-supervised rehabilitation, creditors should have timely access to as many sticks (e.g., foreclosure, liquidation, receivership) as possible. Commencement criteria should be performance-based (e.g., non-payment of debt).[14] Procedures for converting an unsuccessful workout or court-supervised rehabilitation into receivership/liquidation should be simple, quick, and sure.

Creditor losses. Serious financial and operational restructuring of distressed companies is also likely to cause losses to financial institution creditors. For example, interest rate concessions or grace periods may reduce the present value of restructured debt, while a debt/equity conversion may leave financial institution creditors with illiquid and virtually worthless shares. In addition, operational restructuring sales of non-core assets or businesses may also precipitate losses for financial institution creditors. Sales proceeds may be insufficient to repay remaining debt on the asset, for example, or a corporate acquirer may refuse to assume all of the business' remaining debt. Such transactions may moreover indicate that all similar collateral is over-valued. Finally, financial institution creditors may be reluctant to transfer restructured corporate debt and/or converted equity to a professionally-managed joint venture on commercial terms if the negotiated price is below the carrying value of the credits/converted equity, in which case the transfer would force loss recognition. Such concerns seem to have discouraged some Korean banks from conveying distressed corporate assets to "corporate

[12] Holders of distressed debt/converted equity, however, will first have to agree on valuations with the private investor.

[13] In Korea, failure on two successive days to honor bills coming due is grounds for receivership.

[14] Experience from Thailand illustrates undesirability of basing commencement criteria on formal determination of accounting insolvency.

restructuring vehicles" (CRVs) for management by corporate turnaround professionals. Rather than risk losses and diminished capital adequacy that could lead to regulator insistence on "prompt corrective actions," equity dilution, or intervention, financial institution creditors may naturally settle for superficial financial restructuring (e.g., balloon payments), discourage sales of non-core assets/businesses, and hang on to over-valued corporate credits/converted equity – thus leaving numerous "zombie" companies to depress corporate sector profits.

As noted at the outset, the resolution of unsustainable corporate debt is important for long-term corporate competitiveness. Thus, for the sake of long-term health of the corporate sector, the government/financial supervisor should be prepared to force and/or induce adequate operational and financial restructuring of distressed companies. Reasonably realistic information on the financial position and performance of companies is a prerequisite for decision-making. This, in turn, highlights the importance of adopting international best practices in loan classification and provisioning according to forward-looking criteria. Thus informed, the authorities may intervene financial institutions whose risk-weighted capital falls below an acceptable minimum or require sales of "excess" NPLs. In Malaysia, for example, any bank with an NPL ratio above 10% was required to resolve the excess promptly or else sell excess to NPLs to the Danaharta public AMC.

But what if the authorities lack the financial resources or political will to intervene additional financial institutions or force a "fire sale" of excess NPLs? In such cases, the authorities may provide regulatory forbearance as a way of encouraging capital-weakened financial institutions to resolve unsustainable corporate debt. Forbearance, which reduces the imminence of intervention risk, may be on loss recognition or capital adequacy (Box 2). Both were tried in the East Asia crisis.

Box 4. Examples of Regulatory Forbearance

Loss recognition:

- Redefinition of non-performing loans (e.g., from 3 months to 6 months of non-payment;
- Immediate reclassification of restructured corporate debt as performing;
- Relaxation of forward-looking criteria for restructured corporate debt;
- Ability to provision net of collateral;
- Multi-period recognition of losses from corporate restructuring and capital reductions;
- Favorable accounting treatment for converted corporate equity

Capital adequacy:

- Some opportunity for financial institutions whose risk-weighted capital adequacy has fallen below some regulatory minimum (e.g., 8%) to grow their way back to capital adequacy.

Forbearance may entail three risks. First, a financial institution may use the period of forbearance to engage in riskier lending to recover its capital position. As a result, if the institution ultimately fails, the costs will be higher. Hence, forbearance should only be allowed for financial institutions whose long-term viability seems reasonably assured, and progress toward time-bound capital adequacy goals should be closely monitored. A second risk is that some types of forbearance on loss recognition may encourage the over-valuation of restructured corporate debt/converted equity and thereby discourage follow-on operational restructuring.[15] It appeared that such forbearance on loss-recognition could discourage loss-averse financial institutions from taking more drastic steps (e.g., liquidation of non-viable companies, sale to strategic investor, transfer of converted corporate equity to a professionally-managed JV, or forced sales of possibly-overvalued non-core assets/collateral. The third risk is that forbearance on loss recognition may impede private re-capitalization of financial institutions. Investors may find it difficult to do due diligence and feel reluctant to invest in a financial institution characterized by murky loan classification and provisioning; overvaluation of restructured credits, collateral, and converted equity; and uncertain capital.

Some observers may suggest that there is always forbearance in a crisis. If so, the issues are how to minimize additional risks to the financial system and how to design forbearance to meet the broader goals of corporate/financial sector restructuring. Any forbearance should be limited in applicability and duration, as suggested above, and be carefully monitored. The above discussion also suggests that any forbearance should focus on capital adequacy instead of loss recognition.

Inter-creditor differences. Assuming a reasonably strong creditor rights/insolvency system, differences among creditors may be more difficult to overcome than debtor/creditor differences. Due to differences in type of credit, exposure, and capital adequacy, financial institutions may vary widely in terms of their willingness to make financial restructuring concessions, pursue follow-on operational restructuring, or provide new money. Both Korea and Thailand tried to bind creditors to inter-creditor arbitration. The *ex post facto* imposition of such arbitration could seem legally problematic. Disputes frequently surfaced. In Korea, for example, the CRCC provided arbitration decisions in 21 cases prior to July 1999, mostly on the allocation of losses from financial restructuring and additional risks from new money. Given close linkages with the regulated financial institutions, it was perhaps natural for the financial supervisor in Korea and Thailand to play some role in enforcing inter-creditor arbitration decisions.[16] Such involvement, however, posses a huge conflict of interest with the financial supervisor's core function of preserving a sound financial system.

Experience with out-of-court workouts under Korea's initial CRA framework highlighted a significant "free rider" problem. In some cases, while major banks were attempting to agree on a workout plan without resorting to court receivership, non-bank financial institutions (NBFIs) held out for better terms – even though their credits were usually unsecured. If creditors could not reach at least 75% agreement on a restructuring plan, creditors had to decide whether or not to put the company into court receivership. Court receivership, however, immediately requires creditors to make higher loan provisions for expected losses and raises the risks of supplier/subcontractor chain bankruptcies and employee layoffs. Knowing this, NBFIs sought to extract concessions from other creditors – many of which were large nationalized banks – interested in concluding a workout agreement. In many cases, large secured creditors relented and gave NBFI a better deal in the financial restructuring of distressed companies.[17]

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[15] In Korea, for example, from mid-1998 until end-2000 (check dates), restructured corporate debt was exempt from forward-looking criteria. Financial institutions received special dispensation to provision restructured debt at 2-20%. In many cases, however, financial data suggested that provisioning should have been at 50% or higher. The authorities allowed converted corporate equity to be carried at the "lower of cost or market." This sounded reasonable. But, in fact, market floats were extremely thin (because the great bulk of converted equity was held by creditors, who were "locked in" for 3+ years) and market prices were often based on speculative hopes of additional creditor concessions to elicit public shareholder acquiescence to planned equity dilution and debt/equity conversions.

[16] For example, Korea's Financial Supervisory Service (FSS) reportedly threatened to fine Hana Bank KRW 6 billion if it failed to provide a promised KRW 11.9 billion of emergency liquidity to Hyundai Petrochemical. *Korea Herald*, April 21, 2001.

[17] Wonhyuk Lim, mimeo, September 2002.

Difficulties in agreeing and implementing out-of-court workouts led to development of the Corporate Restructuring Promotion Law (CRPL), to replace the CRA approach to workouts. The CRPL came into effect in September 2001 and is to remain in force until 2006. Key features include the following:

- The CRPL applies to all financial institutions (including securities companies) plus the KDIC deposit insurer and KAMCO public asset management company (AMC), rather than just major banks and NBFIs.

- Creditors opposed to a restructuring plan can ask those in favor to purchase their claims and, if necessary, can go to court. If creditors ask to be bought out, their credits would be valued at "liquidation value" based on due diligence by an accounting firm hired by the creditors. Dissenting creditors cannot, however, just "free ride" and reap upside benefits without bearing downside risks – e.g., from proportional participation in new credits.

- If creditors with a minimum of 75% of total credits cannot agree on a restructuring plan, the firm in question must proceed to court-supervised composition, reorganization, or liquidation.

- To facilitate debt/equity conversions, the CRPL also lifts the ceiling on equity investments that can be held by financial institutions. Equity write-downs or write-offs, a normal step in debt/equity conversions in Korea, would still need to be approved by at least 2/3 of voting shareholders present at a shareholders meeting.

The CRPL has been used for restructuring of three Hyundai companies (including Hynix and Hyundai Engineering & Construction) and two Ssangyong companies.[18] Replication of a similar approach would better be adopted before a crisis in order to avoid any concerns about *ex post facto* imposition on financial institution creditors.

Other approaches to resolution of inter-creditor differences include suasion and linkages with the formal insolvency system. Reportedly in Malaysia, as reportedly earlier in London, the central bank occasionally asked hold-out creditors to reconsider their opposition to a particular workout arrangement. Out-of-court procedures in both Malaysia and Thailand mimicked creditor approval thresholds in the formal insolvency system. In Thailand, thresholds for creditor approval of a workout agreement were set at 75%, the same as for a court-supervised organization. Thus, in any case where a 75% majority of creditors could not elicit the cooperation of a hold-out minority, they had the option of taking the agreement to Thailand's bankruptcy court for ratification and imposition on hold-out creditors. In Malaysia, CDRC rules required 100% creditor approval of any workout agreement. But lower approval thresholds in other cases – 75% for Companies Act reorganizations and 50% for workouts managed by the Danaharta AMC – may have given creditors some additional incentive to reach agreement in CDRC proceedings.

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Any out-of-court workout proceeds "in the shadow of the law." In at least two areas, strong linkages with formal creditor rights/insolvency law seem important for the efficient functioning of any out-of-court workout regime.

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[18] As of June 2002, the Hyundai restructurings had involved KRW 5.4 trillion in debt/equity conversions, a KRW 1.4 trillion debt write-off for Hynix, rate reductions and term extensions, and KRW 658 billion in new credit for Hynix. Hynix creditors who were opposed to providing new credits accepted conversion of existing debt into equity or zero coupon bonds at a loss rate of close to 75 percent. *Ibid.*

First, it seems essential for debtors to face a credible immediate threat of total loss (e.g., from foreclosure, liquidation, receivership) in order to elicit sufficient cooperation with out-of-court workout efforts.

Second, the ability to rapidly convert an out-of-court workout agreement into a court-supervised reorganization seems the fairest and most expeditious method for dealing with hold-out creditors or public shareholders. Careful attention should be given to absolute priority rules, availability of "cram down," and thresholds for creditor approval – both in court-supervised insolvencies and, by extension, in out-of-court workout proceedings.